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IN THE

Supreme Court of the United States

OCTOBER TERM, 1971

No. 70-60

SUPERINTENDENT OF INSURANCE OF THE STATE OF NEW YORK, AS LIQUIDATOR OF MANHATTAN CASUALTY COMPANY,

Petitioner,

v.

BANKERS LIFE AND CASUALTY COMPANY, ET AL.,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR RESPONDENTS BELGIAN-AMERICAN BANKING CORPORATION AND BELGIAN-AMERICAN BANK & TRUST COMPANY

Preliminary Statement

This case presents the traditional elements of common law fraud involving the conversion of corporate funds. Such claims are cognizable in the New York courts where an action is now pending against all of the respondents here, but, we submit, no violation of the federal securities laws is involved.

Petitioner commenced his action under Section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q(a), and conducted almost six years of discovery in an effort to support the sufficiency of his complaint. Only after petitioner

had completed his discovery and indicated his preparedness for trial did Belgian-American Banking Corporation ("Belgian-American Banking"), Belgian-American Bank & Trust Company ("Belgian-American Trust") and Bankers Life and Casualty Company ("Bankers Life") move in the district court to dismiss the complaint for failure to state a claim under the federal securities laws. (App. 48a) The district court (Herlands, J.), as did the court of appeals in affirming the district court's judgment, considered not only the allegations of the complaint but also petitioner's various unpleaded versions of the facts and concluded that the petitioner failed to state a federal claim under any federal law.

The district court declared that "the complaint, taken as a whole, alleges no more than a common law action for misappropriation of corporate funds by a fiduciary, embezzlement or fraudulent conveyance perhaps, or the distribution of an illegal dividend" (App. 84a), and held there was no federal jurisdiction under either the Securities Act of 1933 or the Securities Exchange Act of 1934. Chief Judge Ryan, in granting identical motions before him by the other respondents (App. 47a, 49a), adopted the opinion of Judge Herlands and concluded that the "fraud alleged was not in the purchase or sale of securities; but was waste of Manhattan's assets by diversion and misappropriation of its securities". (App. 89a) The dismissals were without prejudice to the prosecution of petitioner's pending action in the New York Supreme Court. (App. 90a)

The court of appeals affirmed the judgments of the district court and noted that the alleged fraud "in no way affected either the securities markets or the investing public. No stockholders were defrauded, no investor injured.

The purity of the security transaction and the purity of the trading process were unsullied. There was no danger that the securities sold would be overvalued on reaching the public markets." (App. 107a) Petitioner's motions for rehearing and rehearing *in banc* were denied by the court of appeals on September 30, 1970. (App. 112a, 113a)

Questions Presented

1. Should the scope of Section 10(b) of the Securities Exchange Act of 1934 be extended to reach the conversion of the proceeds from the sale of a corporation's portfolio of Treasury bonds, when the converter is the corporation's sole stockholder and when the conversion has no conceivable effect on any investor, any security or any securities market?

2. Does a liquidator have standing to sue on a corporation's behalf under the Securities Exchange Act of 1934, when the corporation itself is barred from suit by reason of the participation and approval of its sole stockholder?

Statement of the Case

Petitioner's statement of facts, devoid of record citations, bears little resemblance to the complaint filed in this action. The issues before this Court arise from the allegations of the complaint as well as all the alleged "facts" which petitioner advanced in the district court as part of a proposed amended complaint claiming relief also under Section 27 of the Securities Exchange Act of 1934, 15 U.S.C. § 77aa, for violation of Section 10(b), 15 U.S.C. § 77j(b), and Securities and Exchange Commission Rule 10b-5, 17 C.F.R. 240.10b-5. Both district court judges and

the court of appeals extended to petitioner wide latitude and properly construed the complaint together with its proffered amendatory allegations as not stating any federal claim for relief.

Petitioner's claim, in essence, is that the individual defendants purchased all of the outstanding stock of Manhattan Casualty Company ("Manhattan") for $5,000,000 from Bankers Life, paying for the stock with the proceeds of the sale of United States Treasury bonds which they took from the treasury of Manhattan immediately after they got control. The steps taken were in brief as follows:

First, defendants Standish T. Bourne and James F. Begole agreed to purchase from Bankers Life all of the stock of Manhattan and on January 19, 1962, executed a contract with Bankers Life as seller and Begole as purchaser, providing for the sale of all of Manhattan's stock for $5,000,000. On January 24, 1962, a check of respondent Irving Trust Company ("Irving") in the amount of $5,000,000 was advanced by Irving and given to Bankers Life and, in exchange, all of the shares of Manhattan were given to Begole. (App. 98a)

On the same day, after gaining control of Manhattan, the individuals sold Treasury bonds from Manhattan's portfolio, realized $4,854,552.67 and credited this sum plus an additional $150,000 in the name of Manhattan at Irving. The $5,000,000 Irving check was then charged against this account. (App. 99a-100a)

In summary, Bourne and Begole then owned the stock of Manhattan, Bankers Life had received $5,000,000 and Manhattan's assets, having been used to purchase the Manhattan stock, had been reduced by $5,000,000. (App. 100a)

In order to conceal the above, petitioner charges that the individuals used the proceeds of a second Irving loan in the amount of $5,000,000 to purchase a certificate of deposit from Belgian-American Trust, assigned that certificate to another corporation (New England Note Corporation) controlled by them and then used the certificate as security for a loan from Belgian-American Banking to New England. The proceeds of this loan were then used to repay Irving, thus resulting in a complete "wash" transaction. Manhattan's books reflected only the sale of Treasury bonds and the purchase of a certificate of deposit, without reflecting that the proceeds of the sale of the bonds were used to repay Irving and that the certificate of deposit had been assigned to New England and then pledged to Belgian-American Banking. (App. 101a)

The loan and certificate were renewed to January 1963, when Belgian-American Banking refused to renew its loan, and the individuals arranged for substitute credit with another bank. (App. 101a)

In April 1963 the New York Insurance Department discovered the misappropriation of Manhattan's assets and the New York Supreme Court placed the company in liquidation. (App. 101a)

ARGUMENT

POINT I

Although the regulatory power of the Commission and the scope of Rule 10b-5 are to be flexibly interpreted, the provisions of Section 10(b) of the Securities Exchange Act must be appropriately limited by the scope of the protection intended by Congress and by the discretion of the courts in defining the implied liability they have created.

A. *Summary*

The purpose of the federal securities laws and regulations have in no way been impaired by reason of the decision of the court of appeals in this case. Indeed, we are involved here with an effort to extend Section 10(b) and Rule 10b-5 into areas never before reached by any reported case or contemplated by the Congress, *see* Boone and McGowan, *Standing to Sue Under SEC Rule 10b-5*, 49 Texas L. Rev. 617, 622 (1971), and to bring under the federal regulatory umbrella all cases of fraud in the internal management of state corporations whenever a securities transaction was even incidentally involved. The courts, having implied civil liability for violation of Section 10(b) and Rule 10b-5, should define and limit that liability consistent with the Congressional purpose.

Fraud in a securities transaction falls unquestionably within the prohibitions of Section 10(b). This was what Congress sought to outlaw by the securities legislation; nothing the Second Circuit has done here in any way impairs the fulfillment of that purpose.

But fraudulent activity in which a security transaction is peripherally involved has never been viewed as a federal securities law violation. *Pettit* v. *American Stock Exchange,* 217 F. Supp. 21 (S.D.N.Y. 1963). Here the application of Rule 10b-5 to the alleged embezzlement of Manhattan's assets should not turn upon whether the funds diverted were cash deposits or the proceeds of the sale of a portfolio security. The district court properly sought to interpret the broad language of Section 10(b) and Rule 10b-5 in the context of the legislative history and succinctly summarized the four principal categories of situations in which the courts have upheld such claims:

> "In order to sustain a complaint alleging fraud under section 10(b) of the 1934 Act, it must appear with reasonable clarity from the face of the complaint either (1) that a purchase or sale of securities is at the crux of a fraudulent scheme; or (2) that inducing a purchase or sale of securities is the object of a fraudulent scheme; or (3) that fraudulent statements, misstatements, or omissions are made in a manner which is reasonably calculated to influence the investing public, or are of the sort which the reasonable investing public might rely upon; or (4) that the trading process is abused through potential market manipulation or the spread of watered stock." (App. 82a)

Only very recently the Second Circuit again refused to extend Section 10(b) liability where it could not be shown to be "in connection with" a securities transaction, as the Act requires. *Drachman* v. *Harvey,* Dkt. No. 35077 (2d Cir. July 21, 1971). The court wrote:

> "In short, §10(b) liability arises only when the alleged fraud between the parties and/or alleged market manipulation or deception is intrinsic to the securities

transaction itself. Where this prerequisite is not met, as here, no federally cognizable interest exists, and the complaint must be dismissed." (Slip op. at 4401-02)

B. *The 1934 Act must be construed in light of the Congressional purpose.*

Section 10(b) must be construed against the background of what Congress was seeking to accomplish when the Act was enacted. This Court has itself emphasized the necessity of considering this section in its proper context. *Securities and Exchange Commission* v. *National Securities, Inc.*, 393 U.S. 453, 466 (1969).

The Securities Act of 1933 (15 U.S.C. § 77a, *et seq.*), enacted after the revelation of numerous stock swindles, focused primarily on disclosures required in the initial offering of securities to the public. From that law the public can today rely on the required periodic and annual reports by public corporations, upon the process of registering securities to be offered to the public, and upon the full disclosures required in prospectuses to be delivered in connection with distributions of securities to the public. The Securities Exchange Act of 1934 (15 U.S.C. § 78a, *et seq.*), enacted a year later, can be said to have been aimed primarily at the secondary markets, particularly emphasizing the necessity for full disclosure and fair dealing in the buying and selling of securities in the market. This Act created the Securities and Exchange Commission as a watchdog over the securities industry and contains numerous explicit prohibitions against market manipulation and deceit in purchasing and selling securities in those markets. Those sections in which specific remedies were given to private individuals under the Securities Exchange

Act have been similarly directed to those two facets of securities dealings: disclosure of material facts in the securities transaction and prohibitions against market manipulation. *See* Sections 9(e), 16(b) and 18(a) (15 U.S.C. §§ 78i(e), 78p(b) and 78r(a)).

Both Section 10(b) and the Commission's Rule, now having been accepted by the lower courts as forming the basis of civil liability, *see, e.g., Fischman* v. *Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951), must be applied broadly and flexibly, as the Commission properly urges, but such broad and flexible interpretation must be consistent with and in furtherance of the Congressional purpose. However desirable it might have been for Congress to outlaw all fraudulent activity in the management of corporations, it has not done so and Section 10(b) was not so intended. The state laws are fully effective in this area, *N. Y. Bus. Corp. Law* §§ 719, 720 (McKinney 1963), as are the state courts, *New York Credit Men's Adjustment Bureau, Inc.* v. *Weiss*, 305 N.Y. 1, 110 N.E.2d 397 (1953).

The conclusion that some limitations on the applicability of Rule 10b-5 exist is beyond dispute. It is fundamental, for example, that the Rule may not be applied to transactions not intended to be reached by Congress in enacting the statute that authorizes the Commission to promulgate the Rule. Although the legislative history of Section 10(b) and Rule 10b-5 is sparse, *see* Bromberg, *Securities Law: Fraud, SEC Rule 10b-5*, Sec. 2.2, (1970), the committee reports that are available indicate that manipulative practices affecting the market price of stock were the chief target of the legislation. *See, e.g.*, S. Rep. No. 792, 73d Cong., 2d Sess. 7-8 (1934), which states:

> "Among such practices are fictitious or 'wash' sales; 'matched' orders, or orders for the purchase and sale of the same security emanating from a common source for the purpose of recording operations on the tape and thereby creating a false appearance of activity; and other transactions specifically designed to manipulate the price of a security."

Congress directed this remedial legislation, not to bring corporate fraud cases into the federal court, but to protect the trading process and the securities market and to protect the investing public from fraud in securities trading. The Second Circuit wrote:

> "The dominant congressional purposes underlying the Securities Exchange Act of 1934 were to promote free and open public securities markets and to protect the investing public from suffering inequities in trading . . . ." *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 858 (2d Cir. 1968), *cert. denied sub nom. Coates* v. *Securities and Exchange Commission*, 394 U.S. 976 (1969).

Furthermore, the Fifth Circuit wrote even more recently:

> "By section 10(b) Congress meant to prevent manipulation and control of the prices at which securities are bought and sold and to enable buyers, sellers, and traders of securities to make a proper appraisal of the value of securities." *Herpich* v. *Wallace*, 430 F.2d 792, 801 (5th Cir. 1970).

See Boone and McGowan, *Standing to Sue Under SEC Rule 10b-5*, 49 Texas L. Rev. 617, 622 (1971).

The Securities Exchange Act of 1934 was, after all, an Act "To provide for the regulation of securities exchanges and of over-the-counter markets operating in interstate

and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes", 48 Stat. 881 (1934). *See also* S.Rep. No. 1455, 73d Cong., 2d Sess. (1934); § 2 of the 1934 Act, 15 U.S.C. § 78b.

The provisions of the 1934 Act itself also indicate that there should be some restraint. In the first place, the Act is a criminal statute, § 32, 15 U.S.C. § 78ff, and as such was originally intended to be strictly construed. Second, Congress made clear distinctions among the several sections of the Act. The typical structure was to proscribe certain activities prevalent in the trading markets with the words: "it shall be unlawful . . . .", §§ 5; 7(c), (d); 8; 10; 11(b), (d); 12(a); 14. When the Congress intended that civil liability attach to violations of its proscriptions in other sections, it made that purpose quite clear, §§ 9(e), 16(b), 18(a). Specifically, "when Congress intended to protect the stockholders of a corporation against a breach of fiduciary duty by corporate insiders, it left no doubt as to its meaning", *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461, 464 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952), referring to § 16(b).

C. *The Courts have implied a private remedy under Section 10(b) and should limit that remedy consistent with the Congressional intent.*

Even with respect to those provisions of the 1934 Act as to which the lower courts have implied private remedies, those courts have consistently attempted to articulate limitations on the scope of the Securities Exchange Act to avoid a construction which could sweep within the exclusive federal jurisdiction all questions of corporate

affairs. *See, e.g., O'Neill* v. *Maytag,* 339 F.2d 764 (2d Cir. 1964), in which the court focused on whether full disclosure had been accomplished with respect to the stockholders; finding that such disclosure existed, the court refused to hold that a question of corporate mismanagement was sufficient to bring the conduct within the scope of the Securities Exchange Act.

Whether the policy analysis has been stated in terms of the effect on investors or the securities markets, as was done in this case and has been done in other cases, *see, e.g., O'Neill* v. *Maytag, supra; Drachman* v. *Harvey, supra; Securities and Exchange Commission* v. *Texas Gulf Sulphur Co., supra,* or has taken the form of imposing limitations on standing, either with notions of "privity", *Joseph* v. *Farnsworth Radio & Television Corp.,* 198 F.2d 883 (2d Cir. 1952), or with the purchaser and seller requirement, *Birnbaum* v. *Newport Steel Corp., supra,* it has been universally recognized that Rule 10b-5 must be read in light of the Congressional purpose sought to be achieved. That purpose is not frustrated by the decisions below in this case.

This Court and the courts of appeal have been diligent in effectuating the Congressional purpose in enacting the Securities Exchange Act, *J. I. Case* v. *Borak,* 377 U.S. 426, 433 (1964); *Fischman* v. *Raytheon Mfg. Co., supra.* However, the courts have also recognized that an overbroad interpretation of Rule 10b-5 will destroy its effectiveness.

> "Considered alone, the sweeping language of Rule 10b-5 creates an almost completely undefined liability . . . . Without further delineation, civil liability is formless,

and the area of proscribed activity could become so great that the beneficial aspects of the rule would not warrant proscription." *Herpich* v. *Wallace, supra,* 430 F.2d at 804.

Since the courts originated the concept of implied civil liability under the Exchange Act, it is for the courts to "construct workable limits to liability under section 10(b) and Rule 10b-5 which will accommodate the interests of investors, the business community, and the public generally." *Herpich* v. *Wallace, supra,* 430 F.2d at 805.

This is not to imply that the creation by the lower courts of implied civil liability was incorrect. The time for that argument has presumably long since passed. It does clearly indicate, however, that it is appropriate for the judiciary to impose workable limitations on the statute and its underlying rule when they were clearly intended to be limited. The expansion of remedies under the Act was found necessary to effectuate the intent of Congress in enacting certain provisions of the 1934 Act. Granted that the courts had the duty to create new remedies to effectuate the legislative intent, the courts have the additional responsibility to ensure that their creativity not be applied in situations remote from that intent, thereby destroying Rule 10b-5 as a workable means of policing the securities market.

D. ***The court of appeals here, responsive to the Congressional purpose and consistent with all prior reported decisions under the 1934 Act, correctly refused to find a federal cause of action.***

Petitioner and the Commission are asking this Court to extend the scope of Section 10(b) into areas never before reached. The Commission seizes on the sale of Manhattan's

Treasury bonds[1]—a sale made on the open market for a full and adequate consideration—as support for its contention that the embezzlement of the proceeds is a federal cause of action, although such embezzlement had no effect on any security, the investment value of any security or any of the securities markets. Such conduct was not what Congress had in mind; no other court has so extended the Act; and, indeed, it is not a subject with which the Commission should even concern itself.

The language of Section 10(b) and the seemingly unlimited language of Rule 10b-5 should not be read in a vacuum. They must be read with an understanding of the purpose for which they were created. All of the decisions relied upon by the petitioner and the Commission properly reflect an appreciation of the basic Congressional purpose to protect the securities markets and the investing public and find securities fraud only in that context. This is precisely the approach properly taken by the courts below.

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[1] No claim under Rule 10b-5 can be made with respect to the certificate of deposit because that certificate was not a "security" as defined in Section 3(a)(10) of the Securities Exchange Act of 1934. Section 3(a)(10) defines "security" in general terms, but specifically excludes "any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months * * * *" A certificate of deposit for cash, representing as it does only a negotiable time note, draft, or bill of exchange, is necessarily excluded from the definition of "security".

The definition does mention a "certificate of deposit, for a security", which is intended to refer to certificates which reflect an interest in equity securities deposited with a bank. For example, reorganization trustees have on occasion deposited securities with a bank, and issued participation certificates; similarly, certain banks have issued certificates reflecting an interest in securities held abroad, in bearer form, commonly known as American Depositary Receipts. Congress obviously intended to include certificates which reflect an interest in securities within the definition of "securities" under the Securities Exchange Act. *See* Loss, *Securities Regulation*, 460-65, 795-96 (2d ed. 1961 and 1969 supp.).

The first real attempt at reconciling the Congressional intent with the needs of investors, the business community, and the public at large was the Second Circuit's decision in *Birnbaum* v. *Newport Steel Corp., supra.* There, the defendant—president of Newport Steel Corporation sold his control stock at a premium to a second corporation interested in securing a captive supply of steel during a shortage. The defendant had previously broken off negotiations with a third corporation concerning a merger which would have been beneficial to all the shareholders of the corporation. Plaintiffs, suing derivatively and as representatives of the other minority shareholders, alleged a violation of fiduciary duty and also alleged fraud in connection with certain letters sent out to the minority shareholders by the corporation's president during the merger negotiations. The court adopted the analysis of *Fischman* v. *Raytheon Mfg. Co., supra,* and of SEC Release No. 3230, dated May 21, 1942, that Rule 10b-5 was adopted solely to close the loophole left by the absence of an equivalent of § 17 of the Securities Act as a remedy for defrauded sellers of securities. The Commission only intended to make the same prohibitions applicable to both buyers and sellers, a purpose made clear by the similarity of the language used. Aware of the ability of Congress when it so intends to protect shareholders against breaches of fiduciary duty, § 16(b), 15 U.S.C. § 78p(b), the court reasoned:

> "The absence of a similar provision in Section 10(b) strengthens the conclusion that that section was directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities rather than at fraudulent mismanagement of corporate affairs, and that Rule X-10B-5 extended protection only to the defrauded purchaser or seller." 193 F.2d at 464

This purchaser-seller requirement, adopted by every circuit which has considered it,[2] has been liberally interpreted by the courts to accommodate the novel forms of fraud referred to in *A. T. Brod & Co.* v. *Perlow*, 375 F.2d 393 (2d Cir. 1967). *See also Crane Co.* v. *Westinghouse Air Brake Co.*, 419 F.2d 787 (2d Cir. 1969), *cert. denied*, 400 U.S. 822 (1970). The Commission contends that this expansion has not been broad enough and that this requirement should now be abolished, but agrees with these respondents that this case does not present a proper vehicle for review of that holding since Manhattan was a seller of the Treasury bonds. (Br., at 7, n. 6)[3] The long established purchaser-seller requirement effectively carries out the Congressional intent in limiting the scope of the rule to fraud in transactions affecting securities.

The Commission objects to the refusal of the courts below to consider the sale of securities and the fraud per-

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[2] *Iroquois Industries, Inc.* v. *Syracuse China Corp.*, 417 F.2d 963 (2d Cir. 1969), *cert. denied*, 399 U.S. 909 (1970); *Greenstein* v. *Paul*, 400 F.2d 580 (2d Cir. 1968); *Herpich* v. *Wallace*, 430 F.2d 792 (5th Cir. 1970); *Mader* v. *Armel*, 402 F.2d 158 (6th Cir. 1968), *cert. denied sub nom. Young* v. *Mader*, 394 U.S. 930 (1969); *Dasho* v. *Susquehanna Corp.*, 380 F.2d 262 (7th Cir.), *cert. denied sub nom. Bard* v. *Dasho*, 389 U.S. 977 (1967); *Greater Iowa Corp.* v. *McLendon*, 378 F.2d 783 (8th Cir. 1967); and *Erling* v. *Powell*, 429 F.2d 795 (8th Cir. 1970).

[3] Although the petitioner does not claim to be suing on behalf of creditors or policy holders and does not even allege that there are any, the Commission asserts that the petitioner here should nevertheless be permitted to sue on behalf of "the creditors of the company". (Br., at 28) As pointed out in Point II below, creditors have no standing to sue under the 1934 Act, and the reasoning of the Second Circuit in *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952), and the other courts following it support the creditors' lack of standing. But since this is not a creditor's case, *Birnbaum* is not involved.

petrated as two parts of the same transaction. The lower courts realized that there had been a securities transaction —the Government bonds had been sold out of Manhattan's portfolio, but at a price that was concededly fair. They also realized that the assets of Manhattan had been misappropriated. But the lower courts concluded correctly that these were separate actions. The essence of the plan was the misappropriation of the assets of the corporation. The fact that the misappropriation involved the proceeds of the sale of securities does not change the basic form of the transaction. If the individual defendants removed the bonds from Manhattan's vault, sold them and absconded with the proceeds, there would have been no 10b-5 violation within the Congressional intent. The fact that they sold the securities first and then converted the proceeds should not change this result. "Rule 10b-5 was not intended to provide a remedy for schemes amounting to no more than 'fraudulent mismanagement of corporate affairs'", *Superintendent of Insurance of the State of New York* v. *Bankers Life and Casualty Co.*, (106a), quoting in part *Birnbaum* v. *Newport Steel Corp., supra* at 464.

The complaint here was not dismissed because Manhattan was neither a purchaser nor a seller, nor was it dismissed because Manhattan was not deceived. The conclusion of the lower courts was that the deceit in no conceivable way could affect the persons or the markets or the purposes intended to be protected or effectuated by the Congress in passing Section 10(b) and authorizing Rule 10b-5.

> "The fraud alleged in this case in no way affected either the securities market or the investing public. No stockholders were defrauded, no investor injured. The purity of the security transaction and the purity of

the trading process were unsullied. There was no danger that the securities sold would be overvalued on reaching the public markets." (App. 107a)

If such fraud were taken to be within the scope of Rule 10b-5, then the Rule itself is outside the mandate of Congress and is void. An examination of the cases since *Birnbaum* reveals that the courts have invoked a simple test of whether the transaction involved comes within the scope of Congressional intent. *Crane Co.* v. *Westinghouse Air Brake Co., supra* at 798.

Although actionable under state law, common law fraud for all types of corporate mismanagement is not proscribed by federal securities laws, *Iroquois Industries, Inc.* v. *Syracuse China Corporation,* 417 F.2d 963 (2d Cir. 1969), *cert. denied,* 399 U.S. 909 (1970); *Mutual Shares Corporation* v. *Genesco, Inc.,* 384 F.2d 540 (2d Cir. 1967). The question presented here is to what extent the securities markets must be involved to warrant application of federal sanctions to a fraudulent practice. Actions under § 10(b) and Rule 10b-5 will not be sustained where "purchase or the sale of securities . . . is only incidental to a major mismanagement issue," *Pettit* v. *American Stock Exchange, supra. See Lester* v. *Preco Industries, Inc.,* 282 F. Supp. 459 (S.D.N.Y. 1965); *Kaminsky* v. *Abrams,* 281 F. Supp. 501 (S.D.N.Y. 1968). The issue in each case is whether or not defendants' alleged misconduct is so closely involved with the securities trading process that it falls within the ambit of the 1934 Act, making federal jurisdiction appropriate. Every decision cited by the Commission focuses upon the nature of the effect of the alleged misconduct upon the securities market or investors.

In *Hooper* v. *Mountain States Securities Corporation,* 282 F.2d 195 (5th Cir. 1960), *cert. denied,* 365 U.S. 814

(1961), a trustee in bankruptcy brought an action under § 10(b) and Rule 10b-5 on behalf of Consolidated American Industries, the bankrupt. The former secretary and former general counsel of Consolidated had written fraudulent letters to Consolidated's transfer agent to deceive him into believing that he could appropriately issue 700,000 shares of stock, valued on the market at about $1 per share. In return for various rights valued at about $40,000, the shares were issued to Mid-Atlantic Development Company, a creature of the conspirators that had already been dissolved. The shares were ultimately distributed to the individual conspirators, and over 400,000 shares were sold in turn to unknowing investors on the market.

In finding a cause of action under Rule 10b-5, the court pointed out that the persons sought to be protected by the Act were those engaged in buying and selling and trading in corporate securities. Moreover, the issuance of 400,000 and more shares of watered stock to public investors was precisely the kind of abuse that Congress sought to proscribe. *Ruckle* v. *Roto American Corporation,* 339 F.2d 24, 28 (2d Cir. 1964).

In *A.T. Brod & Co.* v. *Perlow, supra* at 393, plaintiff broker received orders to buy certain securities from defendants. After observing that the securities had failed to rise in value by the settlement date, the defendants refused to pay. The orders had been placed and the securities traded on the New York Stock Exchange. In finding a valid cause of action under the securities laws, the court emphasized the impact on the trading process and noted that the

> "artificial demand created by purchasing securities which are not to be paid for unless the market value

of the stock rises, can have an unsettling and potentially manipulative effect upon the securities market —contrary to the very purpose of the Act." 375 F.2d at 397.

In *Schoenbaum* v. *Firstbrook*, 405 F.2d 215 (2d Cir. 1968), *cert. denied sub nom. Manley* v. *Schoenbaum*, 395 U.S. 906 (1969), the original three-judge panel, 405 F.2d 200, found that a corporation could bring a Rule 10b-5 action where it had been deceived as to investment value. The entire court, in agreement on that point, found that if the transaction involved deception of the minority shareholders by diluting their shares through the issuance of treasury stock for less than fair value, a good cause of action had been stated.

Crane Company v. *Westinghouse Air Brake Company*, 419 F.2d 787 (2d Cir.), *cert. denied*, 400 U.S. 822 (1970) presented a classic example of judicial willingness to apply Rule 10b-5 where the court found a dramatic effect on the market. Crane sought to take over Air Brake, much to the concern of Air Brake's management and American Standard, Crane's chief competitor. Crane made a tender offer for Air Brake's shares, offering $50 in stock and debentures up to a certain date. Around the same time, Standard and Air Brake announced plans to merge, the plan being to exchange Air Brake common stock for a new Standard preferred stock. Standard bought large quantities of Air Brake common on the Exchange, including huge blocks of shares on the last day of Crane's tender offer. These Standard purchases were made at increasingly higher prices—up to $50 per share—during that last day which would give the impression to the average investor watching the trading on the Exchange that the Air Brake shares

would be worth more than the $50 Crane was offering. At the same time, Standard sold large blocks of Air Brake stock privately off the Exchange at a substantial loss. "Standard's extraordinary buying here, coupled with its large secret sales off the market, inevitably distorted the market picture and deceived public investors," 419 F.2d at 793. The *Crane* court found that "[T]he purpose of Congress in enacting sections 9(a)(2) and 10(b) was to *protect the investing public from manipulation and deception by the use of devices which defrauded or misled investors in securities transactions*" (emphasis added), 419 F.2d at 798, and quoted with approval the thrust of its earlier decision in *Securities and Exchange Commission* v. *Texas Gulf Sulphur Co., supra* at 860:

> "[The phrase 'in connection with the purchase or sale of any security'] intended only that the device employed . . . be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities."

See Kahan v. *Rosenstiel,* 424 F.2d 161 (3d Cir.), *cert. denied sub nom. Glen Alden Corp.* v. *Kahan,* 398 U.S. 950 (1970); *Herpich* v. *Wallace, supra; Marino* v. *Coburn Corp.,* CCH Fed. Sec. L. Rep. ¶ 92,959 (E.D.N.Y. February 19, 1971) at p. 90,542.

Each of these decisions emphasizes that the evil Congress sought to avoid was the deception of investors, typically centering on the value of the security in question. The Commission in its brief (at 21) criticizes the court of appeals' decision for finding no cause of action because there was no deception as to investment value. The Commission points out that the opinion in *A. T. Brod & Co.* v. *Perlow, supra,* decided that Rule 10b-5 was not meant to

deal only with fraud as to the investment value of securities, citing *Hooper* v. *Mountain States Securities Corporation, supra.* This misses the point. In both *A. T. Brod* and *Hooper,* the plaintiff suffered a loss because the value received was less than the value given. In *A. T. Brod,* the broker did not receive the sales price of the securities ordered and he was forced to sell at a loss; in *Hooper* stock worth $700,000 was exchanged for rights worth much less. The court of appeals meant only that there was no claim that equal value was not received in the sale of Manhattan's Treasury bonds. Therefore, since there was no harm at that point, no investor, *e. g.,* in Government bonds, could have been injured. The court went on to find that the harm occurred at a subsequent point—the misappropriation of the proceeds. This act of mismanagement, determined to be a separate act with independent legal significance, does not give rise to a claim for securities fraud, because it only involved a closed corporation and had no effect on the securities markets or investors.

The heart of the Commission's position seems to attack the separation of the fraud from the securities transaction by the courts below, yet this fraud would not come under the federal securities laws even if this were to be viewed as a unified transaction. The only security in which there was any public or private market—the Treasury bonds—traded at a concededly fair price. The only possible detriment caused by the entire transaction—even considered as a unitary transaction—was an embezzlement loss suffered by Manhattan. Under the peculiar facts of this case, not even this loss is within the intent of Congress in passing the 1934 Act. There was no public market in the stock—the shares were not traded on any regulated exchange or over-

the-counter. There was not even a private market in the stock—100% ownership has always rested with a single corporation. As the court of appeals put it, "the purity of the security transaction and the purity of the trading process were unsullied." (107a)

Finally, the principal architect of the loss to the corporation was the *sole* owner of the corporation. Any loss realized by the corporate shareholder was self-inflicted; the only conceivable loss would be to the creditors of Manhattan, when it was later liquidated, but no loss to creditors is even alleged in the complaint and, in any event, that loss would be peculiarly the concern of New York law, and would be determined by New York courts.

In *Schoenbaum* v. *Firstbrook, supra,* there were minority shareholders injured by such deception. But not even *Schoenbaum* can be stretched to deal with the unique situation here, namely, that the sole shareholder being defrauded was also the alleged leader of the conspiracy.

Since the sole stockholder could not conceivably have been deceived, the petitioner is left with the argument that the insider who sold the bonds implied a promise not to misappropriate them or their proceeds. An analogous argument was presented to the Second Circuit in *Mutual Shares Corporation* v. *Genesco, Inc.,* 384 F.2d 540 (2d Cir. 1967) and rejected in part on the reasoning of the S.E.C.'s *amicus* brief.[4]

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[4] "The contention that plaintiffs were injured by defendants' failure to disclose their alleged intention, if they should obtain control of Kress, to misuse its assets and otherwise to mismanage Kress presents a somewhat more difficult question. It seems to us that plaintiffs' position in this regard, insofar as Rule 10b-5 is concerned, comes down to the proposition that defendants must be held to have impliedly represented, not only to Kress stockholders to whom their offers were addressed but to the world at large,

Finally, the Commission claims that "the failure of the defendants to disclose their intention to misappropriate the proceeds from the sale of Manhattan's portfolio securities and their misrepresentation that such proceeds would be used to purchase a certificate of deposit for Manhattan in a like amount were clearly material." (Br., at 21). But the Commission does not identify to whom defendants should have disclosed "their intention to misappropriate." The purchasers were not interested; they got full value for their money. Manhattan, the seller, must be charged with full knowledge through the participation of the sole stockholder.

In any event, just as the "implied representation" theory was properly rejected in *Genesco, supra,* because a contrary result would mean that any instance of corporate mismanagement would be turned into a securities law claim, so this analogous contention must be rejected here. The claim that Genesco failed to announce that it intended to divert the assets of Kress to its own pension fund is indistinguishable from the claim that the alleged conspirators here failed to reveal that they would convert the proceeds from the sale of the Treasury bonds.

In the instant case, there were no investors, no markets and no information withheld from any shareholder of

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that they would not mismanage Kress if they acquired control and that plaintiffs relied upon this implied representation when they purchased Kress shares after defendants had obtained control, and that consequently there was fraud on plaintiffs in connection with plaintiffs' purchases. We think this proposition is too broad. It would convert practically any instance of corporate mismanagement into a Rule 10b-5 case, since any shareholder could contend that at the time when he purchased the shares he relied on an implied representation by management that they would not mismanage." (S.E.C. Brief, at 6)

the corporation. In such circumstances, imposing liability under the federal securities laws would not effectuate Congressional intent or come within the legislative purpose. If the alleged conspirators had merely stolen money from the till of Manhattan there would be exactly the same absence of effect on the non-existent outside investors and the public market.

It was never intended that federal law should supersede state law relating to corporate mismanagement. *See Birnbaum* v. *Newport Steel Corp., supra; Lester* v. *Preco Industries, Inc., supra; Kaminsky* v. *Abrams, supra; Barnett* v. *Anaconda Company,* 238 F.Supp. 766, 770 (S.D.N.Y. 1965); and Loss, *Securities Regulation* 3870 (1969 Supp.).

The Fifth Circuit recently stated:

> "If Congress had intended that the federal courts inquire into every decision affecting the management of corporations and then fashion a new federal law superseding state law on the fiduciary responsibilities of corporate directors, officers, and controlling persons, presumably so revolutionary a federal intervention into an area traditionally handled by the states would have been clearly expressed." *Herpich* v. *Wallace, supra,* 430 F.2d at 809.

The same warning was sounded even more recently by the Second Circuit, which after all has dealt with most of the cases arising under Rule 10b-5, and which in the instant case denied rehearing *in banc*:

> "Even giving § 10(b) and Rule 10b-5 the most liberal construction, *i.e.*, that courts should not blind themselves to the fact that 'Congress' purpose in enacting § 10(b) of the Exchange Act was to protect the public by broadly prohibiting *all* fraudulent schemes in con-

nection with the purchase or sale of securities,' irrespective of their novelty or atypicality, nothing is to be found in the history of that legislation, or in subsequent discussions thereunder, to indicate that Congress was enacting securities legislation for the purpose of conferring jurisdiction on the federal courts over corporate mismanagement situations absent fraud intrinsic to the securities transaction itself, which is all that the facts of this case present. Appellants have their remedies in other forums for such misfeasance as there may have been." *Drachman* v. *Harvey, supra,* slip op. at 4403-04.

POINT II

Manhattan could not challenge the securities sale, nor can petitioner now sue on its behalf, since Manhattan's sole stockholder ordered the sale.

A. *Summary*

Petitioner and the Commission have constructed their legal theory around a claimed fraud on the Manhattan directors, ignoring the obvious fact that the directors could not possibly have any claim of their own and that any claim of Manhattan would be barred by the active participation and approval of its sole stockholder.

At least the Commission appreciates the predicament faced by petitioner and seeks to salvage the situation by asserting that the petitioner must really be suing for "injured creditors and policy-holders." (Br., at 27) This effort must also fail for two reasons: (1) Petitioner is not even purporting to sue for creditors (App. 4a), nor has he alleged that there are any; and (2) in any event, creditors have no standing under the federal securities laws to sue directly for an alleged fraudulent sale by the corporation.

B. *Manhattan has no claim, nor does petitioner as its liquidator.*

The essence of fraud is, of course, misrepresentation and deceit. Consequently Manhattan cannot be injured by any fraud when its sole stockholder (Begole) was aware of all the circumstances of the challenged sale and himself ordered the sale. *Old Dominion Copper Mining & Smelting Company* v. *Lewisohn,* 210 U.S. 206 (1908); *Field* v. *Lew,* 184 F. Supp. 23 (E.D.N.Y.), *aff'd sub nom. Field* v. *Bankers Trust Company,* 296 F.2d 109 (2d Cir. 1961), *cert. denied,* 369 U.S. 859 (1962). *See Schoenbaum* v. *Firstbrook, supra,* 405 F.2d at p. 220. To speak of fraud on directors in such circumstances is unrealistic and reflects the straining by petitioner to locate some nail, however precarious, on which to hang his federal theory.

Petitioner, as liquidator of Manhattan, stands in no greater position. He alleges that he is "vested with title to all property, contracts and rights of action of Manhattan" (Complaint, par. 2; App. 4a); it must follow that he is precluded from recovery by reason of the same defenses applicable to an identical suit by Manhattan itself.

> "A corporate officer who uses corporate funds for his own purposes may be liable for conversion to the corporation and in bankruptcy to the trustee. Since the officer had no title to the property, transferees of the officer may be similarly liable. However, the general rule of liability does not apply when the officer's acts have been ratified by all the shareholders of the corporation. In that case, the unauthorized acts of the individual become the authorized acts of the corporation, the corporation loses its right of action against the officer, and the corporation, having no right, the trustee in bankruptcy also has no right. (citing authorities) Under the facts of the instant case, the corporation would have no action in conversion

against Lew, any of his transferees, or any one participating in the transfer, because Lew as sole stockholder ratified his own actions." *Field* v. *Lew, supra,* 184 F. Supp. at 27.

A sole stockholder does not, of course, have unfettered discretion in the management of his corporation. He may, as the district court recognized, be held accountable in a proper context in a state court for the "distribution of an illegal dividend" or "fraudulent conveyance." (App. 84a) But in order to sustain a federal claim here, Manhattan must be shown to be a defrauded seller, which the active participation of its owner precludes.

Petitioner, as he has done throughout the case, responds to the above by silence. The Commission obviously appreciates the legal obstacle which makes this case atypical and seeks to solve the problem by referring to "injured creditors and policyholders." (Br., at 27)

But who are these "injured creditors and policyholders"? Petitioner does not purport to sue for them; he has not even alleged that there are any[5] or that Manhattan was even insolvent. He knows that such a claim would expose the truly non-federal nature of his case.

Even if this were a creditor's suit, a creditor (or representative on his behalf) properly has no standing to sue under the 1934 Act. A creditor is neither a seller nor a

[5] A recent decision of the Fifth Circuit, *Bailes* v. *Colonial Press, Inc.*, Dkt. No. 29048, (5th Cir. June 15, 1971), permitted a bankruptcy trustee to sue on behalf of a corporation defrauded into a stock sale by the corporation's promoters. The court did not analyze the standing question, legislative history or cite any authority for the trustee's right to sue. It is, however, different from the present case in that the corporation was bankrupt and had innocent stockholders who had subsequently purchased the corporation's stock.

purchaser of any security. *Birnbaum* v. *Newport Steel Corp., supra.* He may have claims against the corporation, its officers and directors and stockholders, but such claims arise out of state law (*e.g.,* fraudulent conveyance, illegal dividend, waste) and not "in connection with the purchase or sale of any security", 15 U.S.C. 78j(b).

The legislative history of the 1934 Act does not even suggest that creditors (or a representative on their behalf) have any standing to sue under any provision of the Act; the Court should not now in construing Section 10(b) extend the implied civil liability created by the courts to claims of creditors. There is no need to do so; state law is fully adequate.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted,

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August 31, 1971

IN THE

Supreme Court of the United States

October Term, 1970

No. 1159

SUPERINTENDENT OF INSURANCE OF THE STATE OF NEW YORK, as Liquidator of MANHATTAN CASUALTY COMPANY,

Petitioner;

against

BANKERS LIFE AND CASUALTY COMPANY, IRVING TRUST COMPANY, BELGIAN AMERICAN BANKING CORPORATION, BELGIAN AMERICAN BANK & TRUST COMPANY, GARVIN, BANTEL & COMPANY, GEORGE K. GARVIN,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR RESPONDENTS GARVIN, BANTEL & COMPANY and GEORGE K. GARVIN

PRELIMINARY STATEMENT

The preliminary statements set forth in the briefs submitted by respondents Belgian-American Banking Corporation and Belgian-American Bank and Trust Company and Irving Trust Company are hereby adopted by respondents Garvin, Bantel & Company and George K. Garvin.

QUESTIONS PRESENTED

The questions presented as set forth in the briefs of Belgian-American and Irving Trust are hereby adopted by respondents Garvin, Bantel and Garvin.

STATEMENT OF THE CASE

For the purpose of this appeal, the statements of the case set forth in the briefs of Belgian-American and Irving Trust are

acceptable to respondents Garvin, Bantel and Garvin and are hereby adopted.

Whether the securities in question were used by the defendants to repay Irving Trust for its five million dollar loan to purchase Manhattan Casualty, or whether the securities were used to create a certificate of deposit for five million dollars, which certificate was then pledged for a loan of five million dollars, makes no difference with respect to the critical issue presented by this case. Under either interpretation*, Manhattan Casualty's assets were converted and the question is whether that conversion constitutes a fraud in connection with a securities transaction. We submit that it is not.

*Respondent Irving Trust suggests in its brief that the wrongdoing might have occurred one year after the sale of Manhattan Casualty. This interpretation does not alter the main issue of this case as to whether the fraud was in connection with a securities transaction which violated the Securities Acts.

ARGUMENT

I

THE ARGUMENTS SET FORTH IN THE BRIEFS OF RESPONDENTS BELGIAN-AMERICAN AND IRVING TRUST ARE HEREBY ADOPTED BY RESPONDENTS GARVIN, BANTEL & GARVIN.

II

THE CONVERSION OF MANHATTAN CASUALTY'S ASSETS DID NOT CONSTITUTE A FRAUD UNDER THE SECURITIES EXCHANGE ACT OF 1934.

The notion expressed by petitioner and the Securities and Exchange Commission that tortious activity which involves securities in any way is the basis of a cognizable federal claim is simply incorrect. The Securities Acts were not intended as a cure-all for every type of corporate wrongdoing; rather, their provisions relate only to transactions which may adversely affect investors and the integrity of the public securities market. For a particular transaction to be the basis for an action under the Securities Acts, it must be alleged that there was deception, that the deception resulted in a wrong to the detriment of a person protected by the

Securities Acts, and that there was a causal relationship between the securities transaction and the wrong. In their attempt to establish the necessary link between the sale of Manhattan's bonds and the wrong, petitioner and the Commission rely on the allegation that the board of directors of Manhattan was deceived because it was not informed that the proceeds of the bonds would be used to repay Irving Trust for its loan to Begole. Although this argument may have merit logically, it is not consistent with the facts alleged by the petitioner himself. Immediately after Begole became the sole stockholder of Manhattan Casualty, he alone appointed all the members of the board of directors. (App., p. 128a) Manhattan's board was not an independent decision-making body as contemplated by standard corporate law and procedure; it was a rubber stamp for Begole and acted at his pleasure. Therefore, the deception, if any, perpetrated upon the board of directors had no practical effect.

It cannot be seriously argued that if Begole and Sweeny had simply stolen the bonds from Manhattan, sold them and kept the proceeds for themselves, there would be a federal claim under the Securities Acts. This in effect is what happened and the employment of the vote by an impotent board of directors does not change the reality. If Begole had informed the board that the proceeds of the bonds were to be used to purchase Manhattan and if one or more directors had objected, Begole could have easily and promptly removed the dissenters and replaced them with more agreeable persons. The board of directors of Manhattan Casualty was acting directly for and taking orders from Begole, who is the *only* person in this case covered by the provisions of the Securities Acts. Since defendant Begole cannot challenge the sale of the bonds, neither can petitioner who stands in his shoes.

The Commission attempts to overcome this deficiency in petitioner's claim by arguing that petitioner is prosecuting on behalf of Manhattan's creditors and policyholders. If there are such injured persons, they have more than adequate remedies in the New York State courts. It is doubtful, however, that there are such claims in existence, since it is public record that Manhattan's policyholders were fully reinsured shortly after it went into liquidation. Furthermore, the record herein does not reveal any claims or lawsuits by Manhattan's creditors. In any event, the inclusion of creditors and policyholders in the category of those persons permitted to sue under the Securities Acts is a matter for Con-